Registered Domestic Partner
AGI Limitation Discussion

Background

California law establishes a rule for determining the amount that is used to limit certain deductions and credits[1]. Under existing law, all taxpayers are required to use Adjusted Gross Income (AGI)[2] from their federal return. SB 1827 requires Registered Domestic Partners (RDPs) to file state income tax returns using the same rules applicable for married individuals, including a married filing joint (MFJ) return. The intent of this legislation is to make California income tax reporting the same for RDPs as married individuals.

Because federal income tax law does not allow RDPs to file a joint return, SB 1827 provides a special AGI limitation rule for RDPs filing a joint California return. The law specifies that RDPs filing as MFJ add the AGI amounts from their two separate federal returns and use that total to determine the amount of deductions and credits that are limited by AGI[3].

Under current law, 95% of RDPs will pay the same amount of California income tax as paid by married individuals with identical items of tax reporting. The remaining 5% of RDPs[4] will have a different AGI than married individuals[5]. Consequently, the deductions and credits for those RDPs can be different, some substantially, than the deductions and credits for married individuals with identical items of tax reporting.

Issue

What method for computing federal AGI for limitations most closely results in following the intent of SB 1827, which is to make income tax reporting the same for RDPs as married individuals?

Objective

The objective of this paper is to evaluate the extent to which each of four alternative federal AGI computations provide both:

1) Deductions and credits (ultimately California income tax) for RDPs that are as close as possible to the deductions and credits of spouses in the same circumstances.

2) A method of AGI calculation that is least burdensome to RDPs.

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[1] California law uses federal AGI to calculate limitations for certain deductions and credits, including the following:
- Phase out for the deduction for loss from rental real estate activities
- California exemption credit
- Itemized deduction for medical expenses (must exceed 7.5% of AGI)
- Itemized deduction for miscellaneous expenses (must exceed 2% of AGI)
- Phase out of total itemized deductions

[2] In general, the term Adjusted Gross Income (AGI) refers to all items of gross income reduced by certain deductions. Generally, these deductions include business related expenses, losses in the sale or exchange of property, alimony, and deductions for contributions to special tax-favored accounts, such as Individual Retirement Accounts (IRAs) and Health Savings Accounts (HSAs).

[3] RDPs that file a California return as married filing separately (MFS) continue to use AGI from their individual federal returns, without adjustment or modification, to limit deductions and credits.

[4] The FTB's Economic and Statistical Research Bureau estimates that five percent of the 80,000 RDPs would have tax transactions that would result in the federal joint AGI calculated under SB 1827 differing from the joint federal AGI if the RDPs were allowed to file a joint federal tax return. We used the 2004 Personal Income Tax Sample to estimate the percentage of Single and Head of Household filers that would be affected if they file joint returns.

[5] For purposes of this discussion, these differences may be referred to as filing status differences and RDP/spouse differences. Some affect the computation of AGI. Others affect the computation of taxable income or tax credits.

Alternatives

Below are four alternatives for calculating AGI for limitation purposes. The alternatives take into consideration the impacts based on filing status and differences between the federal treatment of an RDP and a spouse in the same circumstances. They also identify the advantages and disadvantages of each method. Alternatives two, three, and four will require a law change. Since existing law prescribes a specific rule for limiting deductions and credits based on AGI, a law change would be necessary to adopt alternative two, three, or four for RDPs that file California returns, including RDPs that file a separate California return. The alternatives are:

1. The Law as Enacted
2. Federal Pro Forma Return
3. Stand Alone State AGI
4. Federal AGI as Adjusted

This paper refers to adjustments to federal AGI for two kinds of differences.

- Those based on filing status differences.
- Those resulting from federal law not recognizing an RDP as a spouse for federal income tax purposes[6].

1. The Law as Enacted - Add the AGI amounts reported on both RDP's federal tax return.

SB 1827 provides that both RDP's AGI amount reported on their separate federal tax returns is added together to determine the federal AGI to be used to calculate certain limitations and credits for the state joint return.

Advantages	Disadvantages
• For the majority of the RDP population this provides a straightforward method for calculating AGI limitation. • No additional forms or returns required.	• This method results in the largest discrepancy in AGI limitations for RDPs and spouses with the same circumstances. • Adds complexity to software programming and preparation time for tax preparers.

2. Federal Pro Forma Return - Combine each RDP's income and "above-the-line" deductions as if filing a federal MFJ return.

The AGI rule would be the amount of the joint AGI as if RDPs filed a joint federal tax return. RDPs would need to complete a pro forma federal tax return as if they were married and use the federal AGI from this return for AGI limitation purposes. The pro forma return would not be filed with the IRS but might be required as an attachment to the California joint return.

Advantages	Disadvantages
• Takes into account filing status and RDP/spouse differences. • Decreases inconsistencies between federal AGI amounts for RDPs and spouses.	• Requires an additional federal return for (although mock) the entire population of RDPs using the filing status "MFJ." • More complex for RDPs in comparing amounts reported on the RDP's joint state tax return to the federal tax return filed with the IRS.

[6] In those limited areas where California law cannot effectively treat an RDP as a spouse, i.e., ERISA, IRAs, etc., it is expected that California law will be clarified to make the federal treatment in these limited areas also applicable for RDPs filing a California return. In those limited areas, California treatment would be the same as federal treatment. Consequently, no adjustment to Federal AGI will be required.

3. Stand Alone State AGI - Calculate a California joint return "from scratch" and use the California AGI to limit deductions and credits.

This alternative would require the taxpayer to file a return using only their state income and deductions. RDPs would not use their federal AGI as a starting figure on their state return. This may require new forms, schedules, and instructions.

Advantages	Disadvantages
• Eliminates federal/state differences between AGIs by providing only a state AGI. • Allows RDPs to start with a state return (no federal return required).	• This method is the most complex for RDPs when taking into account California adjustments[7]. • Adds complexity for the RDP in comparing amounts reported on the RDP's joint state tax return to the federal tax return. • Adds complexity to software programming and preparation for tax preparers. • May add additional forms and schedules for RDPs.

4. Federal AGI as Adjusted - Add the AGI amounts reported on both RDP's federal tax returns and adjust on an instructional worksheet for filing status and RDP/spouse differences.

This alternative would require RDPs who file a California return to start by adding the AGI from their separate federal returns. That total would be adjusted with the use of a Franchise Tax Board (FTB) worksheet (example shown below) to take into account above-the-line differences based on filing status and the differences between the federal treatment of an RDP and a spouse in the same circumstances. Below is an example of an RDP filing a joint state return.

Description	RDP1	RDP2	Fed Amt for each RDP		State Amt for RDP filing jointly
			RDP1	RDP2	
AGIs from separate federal returns					$139,000
Rental Real Estate	<25000>				25,000[8]
Capital Loss	<20000>	<10000>	<3000>	<3000>	3,000
Total Adjustment					28,000
Federal AGI as adjusted					$167,000

Advantages	Disadvantages
• This method results in the smallest discrepancy in AGI limitations for RDPs and spouses with the same circumstances. • From an instructional perspective, this alternative is the simplest.	• RDPs with complex tax returns would need to prepare an additional worksheet.

[7] Example would be interest on the obligations of other states.

[8] The disallowed Rental Real Estate and Capital Losses are added back to the combined federal AGI to arrive at the federal AGI as adjusted for limitation purposes.

Comparative Example

This example illustrates the four alternatives for calculating AGI for limitations purposes. Alternative one is the law as enacted combining two federal AGIs. Alternative two is the federal pro forma return. Alternative three is the stand alone state AGI using state only amounts. Alternative four is the federal AGI as adjusted, which uses the worksheet as shown on page three.

	Federal Return			**State AGI Reporting Alternatives**			
	RDP1	RDP2	MFJ Federal	**Alternative One** (The Law as Enacted)	**Alternative Two** (Federal Pro Forma Return)	**Alternative Three** (Stand Alone State AGI)	**Alternative Four** (Federal AGI as Adjusted)
Wages	$95,000	$75,000	$170,000		$170,000	$170,000	
Rental Real Estate Loss[9]	(25,000)						
Capital Loss/Gain RDP1 ($20,000) RDP2 ($10,000)	(3,000)	(3,000)	(3,000)		(3,000)	(3,000)	
Interest - $10,000 Exempt for Federal Taxable for CA						$10,000	
Total Federal AGI Per Partner	$67,000	$72,000					
AGI			$167,000	$139,000	$167,000	$177,000	$139,000
Worksheet calculations: Rental Loss (No deduction if AGI exceeds $100,000) Capital Loss (Loss limited to $3000)							$25,000 $3,000
Adjusted Federal AGI for limitation purposes				$139,000	$167,000	$177,000	$167,000

Summary

This paper presents four alternatives for calculating AGI for limitation purposes when impacted by filing status and differences between the federal treatment of an RDP and a spouse in the same circumstances. The same considerations are applicable to RDPs filing returns as married filing separate.

It is important to note that regardless of the alternative chosen for AGI limitations, the adjustments required to determine California taxable income for all RDPs with similar circumstances would be the same. They would make traditional adjustments for other differences between federal and California law (often using a California Schedule CA for the applicable return). The paper further illustrates some of the advantages and disadvantages of each method in meeting the Legislature's intent in enacting SB 1827.

We welcome your comments and suggestions.

[9] A taxpayer may claim up to $25,000 of rental real estate losses against nonpassive income. The losses are phased out (meaning the more AGI the taxpayer has, the less loss he or she may take) when the taxpayer's modified federal AGI is between $100,000 and $150,000. If the federal AGI is over $150,000, the taxpayer does not get to claim any of the $25,000 losses.